TESTIMONY OF IRA SHAPIRO

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On China's Exchange Rate Policy

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I appreciate the invitation to appear at this important hearing. This Committee has always been a special place for me, dating back to the 1990's when I had the opportunity to work with distinguished members on both sides of the aisle on the historic trade issues presented by NAFTA, the Uruguay Round and trade disputes with Japan.

I am a former Senate staffer and Clinton administration trade official, now in private law practice. I have a number of clients who have strong and varying views about U.S.-China trade and economic relations, and I have been involved for several years in WTO litigation on behalf of several of the U.S. copyright industries. My testimony is undoubtedly influenced by my experiences, but the views I express here are my own personal views.

In the course of preparing my testimony, I had occasion to read the full record of the Committee's March and June hearings on China's currency, and trade and industrial policies. They were very searching hearings, consistent with the Committee's rigorous approach to critical issues, and the record makes for very sobering reading about the full scope of the challenge presented to U.S. policymakers in choosing a course of action to respond effectively to China's economic and trade policies.

With respect to the issue of China's currency, I feel a particular need for humility. I once turned down the possibility of an important job in the U.S. government because I didn't feel that I understood international financial issues and exchange rates well enough to serve in that position. Our nation, and the global economy, were undoubtedly better served by my modesty. But the issues confronting the Committee, the Congress and the Obama administration are at the intersection of trade law, international economics, politics, and diplomacy, where I feel more comfortable offering a perspective for the Committee to make part of its consideration.

There is a broad consensus among experts that China' s currency, the renminbi (RMB), is seriously undervalued vis-à-vis the U.S. dollar. The experts that have reached that conclusion include Dr. Fred Bergsten and his colleagues at the Peterson Institute, the European Central Bank, and the managing director of the IMF. China's decision in July 2005 to allow the RMB to appreciate against the dollar through a managed floating exchange regime did produce some significant adjustment, approximately 20%. However, China re-established the peg between the RMB and the dollar in 2008 to cope with the international financial instability created by the onset of the financial crisis. China's decision to "unpeg" the currency on June 19 created some new hope, but has only produced a minimal RMB appreciation since then.

As the most recent IMF staff report on China, dated July 29, notes, "the renminbi remains substantially below the level that is consistent with medium-term fundamentals." Significantly, the IMF staff report continues: "The real exchange rate is now back to the level of 1999-2003, a period in which there did not appear to be any decisive imbalance in China's external accounts." However, since then, China's economy has almost doubled in dollar terms, the productivity of China's economy has improved dramatically, and China has large trade surpluses with the rest of the world.

These real world economic forces should have produced a significantly stronger RMB. However, China has prevented this adjustment from occurring by intervening in currency markets. These interventions to keep the currency artificially weak have the effect of supporting China's export-oriented growth strategy, penalizing imports, and producing trade and economic imbalances that cause great damage to the economies of the United States and many other countries. The question for the Committee, the Congress, and the administration, of course, is how best to respond.

I favor taking action, but action that is most likely to bring about the right result for the United States, China and the world economy. In my view, that means maximizing the chances of a successful rebalancing and adjustment of the leading currencies and the global economy, and avoiding the possibility of a cycle of retaliation and a damaging trade and economic war at a time when the U.S. and global economy remain fragile.

For that reason, I am opposed to most of the legislative approaches that are being considered, even while recognizing how much good work has gone into the effort. From every angle that I approach the problem, I prefer a continued effort at multilateral diplomacy and negotiation, and recourse to the WTO when necessary or appropriate.

I reach that conclusion for several key reasons.

First, the question of whether it is possible to rewrite the AD/CVD laws so as to make China's currency a countervailable subsidy has been debated at length. Members of Congress have worked diligently and creatively, in consultation with some excellent trade lawyers, to frame such legislation. I am not an AD/CVD lawyer, but I have worked with those laws for many years. Count me among those who are skeptical that this approach can work. Countervailable subsidies must include a government financial contribution and must be specific to a company or an industry, rather than general. The requirement of "specificity" has not traditionally been associated with a policy, like exchange rates, that has general applicability. The concept of a prohibited export subsidy is one that is targeted on exports, rather than affecting both exports and the domestic economy.

The trade remedies laws have been part of U.S. law and the law of other nations for many years; they remain essential tools for combating unfairly traded imports. When I was in the Clinton administration, as USTR General Counsel, I strongly defended the use of U.S. trade laws against the criticisms of our trading partners. But the basic parameters of these laws are well established. I think it is very doubtful that the United States, or any other WTO member, can break substantial new ground by defining "currency manipulation" as a violation of its countervailing duties law, or discovering that it has always been covered by the WTO agreement on Subsidies and Countervailing Measures (SCM). As a legal matter, I think the efficacy of this approach suffers further from the GATT provision, Article XV (4), incorporated in the WTO, that offers a channel for addressing the question of currency manipulation directly.

Second, while multilateral approaches are generally preferable to proceeding unilaterally, that strikes me as especially true where currency arrangements are concerned, at this particular point in time. We face three overlapping, extraordinary developments: the rise of China, along with other leading developing nations, as prominent global economic players; the continuing fragility of the U.S. economy, and others, in the aftermath of the worst economic crisis since the Great Depression; and the relatively recent effort to launch the G-20 as a new forum and vehicle for leading nations to grapple with fundamental international economic issues. Against this backdrop, dealing with the currency imbalance with China by, in essence, deputizing ourselves to handle it, does not strike me as being a productive course.

If we consider the possible factors most likely to move China in the direction of a strong currency, China's own economic self-interest stands above all others. Despite its astonishing progress and economic growth, China continues to manage an extraordinarily difficult transition, with hundreds of millions of people still battling poverty and swollen, state-owned enterprises still requiring downsizing. China has very sophisticated officials in the international financial realm who understand that a stronger currency would be beneficial: to moving China toward an economy more reliant on domestic demand, combating possible inflation, and rebalancing the global economy. Reportedly, those officials engage in vigorous debate with others disposed to doing everything possible to keep China's export-oriented economy running at full blast. China may also respond to multilateral pressure to accept a leadership role in resolving the imbalances that presently threaten the global economy. In my view, the approach least likely to succeed is United States action taken unilaterally. Such unilateralism could well result in trade or economic retaliation of some type by China, the weakening of those in China who favor moving to a stronger currency for China's own purposes, and reduced support for the United States from other nations who have been adversely affected by China's currency policies.

This assessment reflects, among other things, my experience in 1995 in the trade dispute with Japan over autos and auto parts, which Dr. Bergsten once described as "the most dangerous trade dispute in fifty years." As that dispute heated up, the U.S. had significant potential support from other nations that believed that Japan's auto and auto parts market was closed to foreign participants. However, when the U.S. decided to threaten Japan with $6 billion in sanctions by imposing 100 percent tariffs on Japanese luxury cars, other nations, particularly the European Union, shifted their sympathies to Japan. They showed more concern about possible U.S. unilateralism than Japan's closed markets, in part because the world's trading nations had just created, and put into effect, the WTO for resolving disputes. Similarly today, other nations would believe that the G-20, created to deal with problems like the global economic imbalances, should be given the opportunity to do so, in conjunction with the IMF.

This is not the first time that the leading nations have confronted major trade problems resulting from currency imbalances. In 1971, the Nixon administration responded to the first U.S. trade deficit by putting a 10% tariff on all goods from Japan, and taking the United States off the gold standard. Many economists believe that move contributed significantly to the crippling inflation that hammered U.S. economy later in the 1970's. In 1985, responding to a growing U.S. trade deficit and a Japanese yen that was far too weak, the Reagan administration, led by Treasury Secretary James Baker, orchestrated the Plaza Accord, through the G-7, which led to the managed depreciation of the dollar vis-à-vis the yen. From my standpoint, the approach of the Plaza Accord is a much better model to follow. I think the upcoming G-20 meeting in Seoul would be the right time to launch such a negotiation, to be completed within six months, with the goal being an agreement to rebalance the leading currencies over a 2-3 year period.

If, despite the opportunities over the next few months, it becomes evident that the steps taken by China have been inadequate, and China's currency cannot be revalued through negotiation, I would favor beginning a WTO proceeding against China under GATT Article XV (4). That article provides, in part: "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement." Article XV (2) and (4) also mandate heavy reliance on the IMF, including the obligation to "consult fully" with the IMF, and to rely on the IMF's findings on statistical and other related issues.

No one can guarantee the success of such a WTO action, because there are no GATT or WTO precedents for such an action. The U.S. would bear the burden of convincing WTO jurists that the key terms of Article XV (4) have the meaning that we think they have. The views of the IMF on whether China was engaged in currency manipulation would have great weight. But certainly, China's concerted actions to keep its currency weak, with significant impacts on the U.S. and other trading nations, seem to be "frustrating" the intent of the WTO agreements, as well as violating Article IV, Section 1 of the IMF's Articles of Agreement which commits member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payment adjustment or to gain unfair competitive advantage over other member countries."

It would be important to make every effort possible to bring the European Union, Japan, and as many G20 members as possible on board in support of such an action. I understand that the euro is not pegged to the renminbi, so the EU is less concerned about the issue than we are. In fact, the EU is benefiting right now from the weakness of the euro, vis a vis the renminbi and the dollar. However, the EU's trade imbalance with China has soared in recent years, and many Europeans no longer regard China trade and currency policies as exclusively a U.S. problem. Japan has a clear interest, because it is struggling with a soaring yen, brought about in large part by China's increased purchase of yen-denominated assets. The support of other leading nations, developed and developing, would also be crucial.

My experience, based on the two WTO cases brought on behalf of the copyright industries, is that China increasingly recognizes its responsibilities as a member of the WTO system. It will defend cases vigorously, bring cases when it believes other nations are not in accordance with WTO rules, and ultimately is more likely to comply with an adverse WTO decision than bend to unilateral action.

I am quite certain that the WTO would rather not grapple with such a case. But it is probably true that the WTO would have preferred not to adjudicate the cases brought by the United States and the European Union with respect to aircraft subsidies. The WTO does not get to select the cases that come before it. I recommend this course of action because neither Congress nor the president should ever be in the position of saying: China's currency is a major problem; we should not take actions that are inconsistent with our WTO obligations; but we have no recourse under the WTO with respect to currency, notwithstanding what Article XV (4) seems to say. The multilateral channels are there; they should be used.

Many people have drawn the analogy between the challenge that the U.S. faces with China today and what we faced with Japan 25 years ago. Some dismiss the analogy, because today, after Japan's long period of economic stagnation, it can be hard to recapture the feeling of urgency from that time. I think, however, that the analogy warrants some thought, from a different angle.

If you go back to the mid-1980's, an enormous gap seemed to exist between President Reagan and his Democratic critics with respect to economic and trade policy. For Ronald Reagan, it was "morning in America," and he professed great faith in free markets, free trade and America's ability to compete. Many Democrats, concerned about Japan's rise, were calling for tougher trade policies and "industrial policy."

In fact, it turned out that Republicans and Democrats were looking at the same world, and the same realities. The Reagan administration offered protection to the steel, auto and semiconductor industries; established Sematech to nurture the next generation of semi-conductors; Jim Baker embarked on the Plaza accord negotiation to depreciate the dollar; and the administration and Congress enacted the Omnibus Trade and Competitiveness act. John Young of Hewlett-Packard became the CEO of the newly-created private sector Council on Competitiveness.

Japan made some profound policy mistakes, but the U.S. economic turnaround also reflected three administrations, Republican and Democratic, that embarked on economic and trade policies needed to rebuild our economic strength. I hope that the Obama administration and Congress would see this as a similar situation. The United States faces a continuing economic crisis, which makes the current acrimonious political divisions particularly dangerous. We truly need a new U.S. economic strategy, which can only be credible at home and abroad if it brings together Democrats and Republicans, and the White House and the Hill. And it should be possible to formulate such a strategy. There are many people in both parties who should be ready to enlist in the effort for what Thomas Friedman has called "nation building at home."

In recommending a course of action relying first on negotiations through the G-20 and the IMF, I am influenced by my great confidence in those who represent the United States in international financial negotiations. Secretary Geithner, former Secretary Summers, and Under Secretary Hormats have dealt with, and steered through, many international economic challenges and financial crises, on several continents over several decades. If recourse to the WTO becomes necessary, I also have great confidence in the ability of USTR's lawyers, and the collaboration between USTR and Treasury.

We need to rely on our Executive Branch officials as well because the complex and sensitive U.S.-China relationship demands skillful handling of numerous difficult issues. Although I regard the currency imbalance as fundamentally important, a range of China's trade policies and industrial subsidies pose a challenge every bit as serious as the misalignment of its currency. Moreover, the administration, like its predecessors, needs to work with China on issues as diverse as Iran sanctions, the future of North Korea and the efforts to cope with climate change. The economic pain across our country is intense, and I understand that elected officials want to respond with action. My recommendations today reflect my belief that there is a course of action to be followed, although it will require patience, persistence and diplomacy, and that lashing out against China would threaten our economy, the global economy and the basis for cooperation between the United States and China, which is essential to global prosperity and stability going forward.